

How Dangerous Is the U.S. Current Account Deficit?

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The U.S. current account deficit has attracted considerable attention from academics, policymakers and market participants. So also has the U.S. international investment position—the difference between U.S.-owned assets abroad and foreign-owned assets in the United States. The net position has become increasingly negative as current account deficits have accumulated over time. I have spoken on international topics several times in recent years, emphasizing the importance of international capital flows for explaining the evolution of the U.S. international accounts. I'll review some of my prior analysis today, but want to concentrate on the question in my title.

The question arises because, at some point in the future, the world economy will adjust in ways that yield a smaller U.S. current account deficit. That we know for certain, because a situation in which the U.S. net international investment position becomes ever more negative as a percentage of GDP is inconsistent with long-run equilibrium. So, the question is not whether the U.S. current account deficit will fall in the future but whether the inevitable adjustment is likely to be painful and disruptive of U.S. economic growth and stability—a hard landing.

My answer is that a hard landing is very unlikely provided that U.S. monetary and fiscal authorities maintain sound policies. The Federal Reserve needs to pursue policies that yield low inflation and financial stability, and the federal government needs to pursue policies that yield

fiscal balance in the long run. I believe the current account adjustment will be fairly slow and orderly, and that it may not begin for quite some time.

My answer is also based on a simple observation, which I believe is not widely understood. For the United States, unlike almost every other country in the world, a hard-landing process is inherently self-limiting. U.S. assets owned by international investors are predominantly denominated in dollars, and a large fraction of U.S. assets held abroad are denominated in foreign currencies. Dollar depreciation, should it occur in a hard-landing process, will be self-limiting because the dollar value of U.S. assets abroad will rise, thus improving the U.S. net international investment position. Market participants, knowing this fact, are therefore unlikely to drive down the foreign currency value of the dollar in a rapid and disruptive fashion.

I'll proceed in two steps. First, I'll explore the fundamentals of the U.S. position, emphasizing the central role of international capital flows in creating the current account deficit. Second, I'll develop the theme that the U.S. position is self-correcting, should a hard-landing process begin.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. Two members of the St. Louis Fed's Research Division, Cletus Coughlin, vice president, and Mike Pakko, senior economist, provided special assistance. However, I retain full responsibility for errors.

PRELIMINARIES

The most widely cited measure of the U.S. external imbalance is the trade deficit—the difference between U.S. exports and imports of goods and services. More generally, it is useful to consider the broader concept of the current account, which includes current earnings on capital as well as trade in goods and services. A corresponding account on the other side of the ledger, known as the “capital and financial account,” measures the international flow of capital assets. Putting aside errors and omissions in the data, a current account deficit is necessarily equal to a capital account surplus. A country in this position—like the United States today—is exporting more capital claims than it is importing. Put another way, international investors are bringing more capital to the United States than U.S. investors are sending abroad.

A common mistake is to treat international capital flows as though they are passively responding to what is happening in the current account. The current account deficit, some say, is financed by U.S. borrowing abroad. In fact, international investors buy U.S. assets not for the purpose of financing the U.S. current account deficit but because they believe these are sound investments promising a good combination of safety and return. Moreover, many of these investments have nothing whatsoever to do with borrowing in the conventional meaning of the word, but instead involve purchases of land, businesses, and common stock in the United States. Foreign auto companies, for example, have purchased land and built manufacturing plants in the United States. Clearly, foreign auto producers have established these facilities because of the prospective returns from building vehicles in the United States and not for the purpose of financing the U.S. current account deficit. This simple example should make clear that a careful analysis of the nature of international capital flows is necessary before offering judgments about risks posed by the U.S. current account deficit.

RECENT TRENDS IN THE U.S. INTERNATIONAL INVESTMENT POSITION

The capital account measures asset flows of a country for a given period, such as a year. For the United States, the capital account includes the accumulation of foreign assets by U.S. residents as well as the accumulation of U.S. assets by foreigners.

As trade and commerce around the world have grown increasingly integrated—the process often referred to as “globalization”—the growth of cross-border financial flows has become particularly prominent. For example, foreign ownership of U.S. assets increased by an average of \$155 billion per year during the 1980s. For the years 2000 through 2004, foreign ownership of U.S. assets increased at an average rate of \$991 billion per year—more than a six-fold increase. In 2004, over \$1.4 trillion of U.S. assets were purchased by foreign entities.¹

U.S. ownership of foreign assets has shown similar growth. Averaging \$95 billion per year during the 1980s, U.S. entities have accumulated foreign assets at an average rate of \$484 billion per year over the past five years. Over the entire span of this comparison, accumulation of U.S. assets by international investors has outpaced the U.S. accumulation of foreign assets—a capital account surplus that has moved our country from a positive to a negative net asset position.

Prior to 1989, the United States had had a positive net international investment position since World War I. As a consequence of large capital inflows in the 1990s, the United States today has the world’s largest negative net international investment position. By the end of 2004, foreigners owned more than \$12.5 trillion of U.S. assets, based on market values, while U.S.-owned assets abroad reached a level of just under \$10 trillion. Hence, at the end of last year, the U.S. net international investment position was minus

¹ Data are from the Bureau of Economic Analysis, as reported in the U.S. International Investment Position tables. Direct investment is measured at market value.

\$2.5 trillion, amounting to over 20 percent of U.S. GDP.

In today's world, with electronic funds transfers, financial derivatives and largely unrestricted capital flows, investors have a global marketplace in which to seek profitable returns and diversify risk. In such an environment, we should consider the possibility that aggregate patterns of international trade flows may be the by-product of a process through which financial resources are seeking their most efficient allocations in a worldwide capital market. That is, instead of thinking that capital flows are financing the current account deficit, it may well be that the trade deficit is driven by—is financing, so to speak—capital flows determined by investors seeking the best combination of risk and return in the international capital market. The mechanism creating this outcome is that capital inflows keep the dollar stronger than it otherwise would be, tending to boost imports and suppress exports, thus leading to a current account deficit.

While the conclusion that the current account is financing the capital account is surely an overstatement, because capital and trade flows are jointly determined, it is worth emphasizing that capital flows are a highly dynamic feature of the world economy. Capital flows are driven by a number of economic forces which are not fully understood, especially at a quantitative level. The “home bias” of investors, which has led them to invest in their home countries rather than seek optimal international diversification, has probably been diminishing and, as a consequence, investors everywhere are increasingly investing outside their home countries. Countries with rapidly aging populations, especially Japan and Western European ones, may be saving and investing in the United States against the day when their populations will be drawing down assets to support retired citizens. Because the United States economy has been growing at a faster pace than most high-income countries, investment returns from U.S. operations have tended to

exceed those abroad, thus encouraging capital flows to the United States.

As many have commented, the capital inflow may also reflect the low saving rate in the United States. However, the U.S. saving rate should not be viewed in isolation: Ben Bernanke—a former Fed Governor, current Chairman of the President's Council of Economic Advisors and President Bush's nominee to succeed Alan Greenspan as Federal Reserve Chairman—has persuasively argued that an unusually high level of worldwide savings relative to investment opportunities has resulted in downward pressure on world interest rates.² Investors everywhere seek the best combination of investment return and security, and they have brought abundant capital to the United States because the profitability and security of U.S. investment opportunities make the United States something of an oasis of prosperity and stability.

Some of these economic forces may tend to reduce U.S. capital inflows in the future. For example, as portfolios become more internationally diversified, the incentive for investors abroad to move capital to the United States will diminish. Aging populations may increase purchases of U.S. goods with their accumulated assets. The net of these economic forces in the future may tend to either appreciate or depreciate the value of the dollar on foreign exchange markets.

But one thing is clear: Changes in investor attitudes and expectations can alter capital flows quickly and force changes in the trade account. From this perspective, which I have called the “international capital markets view,” international asset markets play a central role. Capital flows, determined by the motivations of foreign and domestic investors, are a driving force. We should think of capital flows as the equilibrium outcome of investors worldwide seeking to acquire portfolios that balance risk and return through diversification.

When we bear this perspective in mind—that international capital flows are determined

² Bernanke (2005).

by investors' efforts to allocate their capital most efficiently and not by passive financing of the current account—prospects for a painful current account adjustment in the future seem less likely. The fundamental economic determinants of capital flows are unlikely to change quickly and massively, and therefore capital flows themselves are unlikely to change quickly and massively.

A CONSIDERATION OF THE POTENTIAL DANGERS

The potential dangers of current account adjustments can be viewed from a number of perspectives. As we consider some of these scenarios, the international capital markets view will serve to counter some of the concerns.

Many of those who predict adverse consequences of a current account reversal emphasize the risk of a dramatic depreciation of the dollar on foreign exchange markets. If this decline were to take place suddenly, resulting in disorderly markets, a financial-market induced recession might ensue. To properly evaluate the likelihood of this kind of worst-case scenario, we need to consider some alternative views of the forces driving the U.S. current account deficit in the first place.

From a trade deficit view, which I do not share, depreciation of the dollar on foreign exchange markets might be seen as necessary to resolve the excess of U.S. imports over exports. On this view, either the United States will run a persistently widening current account deficit, or we are destined to face some combination of a depreciating currency and/or lower GDP growth. If we look at the situation from the opposite direction, however, we might note that the recent historical trend of a widening U.S. current account deficit has taken place in an environment in which U.S. GDP growth has been, on average, higher than growth in much of the rest of the world.

Indeed, we did see some depreciation of the dollar from early 2002 through 2004, by a bit less than 30 percent as measured by the major-currencies trade-weighted index. However, the

index has rebounded by about 6 percent so far in 2005. The depreciation, on balance, since 2002 has made U.S. exports more competitive and has led to some price increases in U.S. imports. These are the types of adjustments that take place in market economies in response to evolving supply and demand conditions. The recent depreciation of the dollar can be seen as part of the normal adjustment process of the economy, and markets have not shown any signs of becoming disorderly.

An emphasis on savings and investment as drivers of international capital flows appears incomplete and not completely in accord with recent facts. What is needed, I believe, is a more explicit focus on the unique role of U.S. financial markets in the world economy.

THE U.S. ROLE IN INTERNATIONAL CAPITAL MARKETS

The globalization of financial markets—spurred by technological advances and liberalization of capital flow restrictions worldwide—has created entirely new investment opportunities for investors in both the United States and abroad. These new opportunities have undoubtedly given rise to a re-balancing of portfolios, and there are reasons to believe that this process might be associated with a net export of claims on U.S. assets, yielding a current account deficit.

U.S. financial markets are among the most highly developed in the world, offering efficiency, transparency and liquidity. The U.S. dollar serves as both a medium of exchange and a unit of account in many international transactions. These factors make dollar-denominated claims attractive assets in any international portfolio. No capital market in the world has a combination of strengths superior to that of the United States. Our advantages include the promise of a good return, safety, secure political institutions, liquidity and an enormous depth of financial expertise.

For some purposes, it is useful to think of U.S. financial markets as serving as a world financial intermediary. Just as a bank, or a mutual fund, channels the savings of many individuals toward

productive investments, the U.S. financial markets play a similar role for many investors from around the world. In the process, individuals, companies, and governments accumulate dollar-denominated assets to serve as a vehicle for facilitating transactions and storing liquid wealth safely.

A bank earns its return on capital by paying a lower interest rate to depositors than it earns on its assets. Similarly, the United States earns a higher return on its investments abroad than foreigners do on their investments in the United States. Despite the fact that the U.S. international investment position at the end of 2004 was $-\$2.5$ trillion, U.S. net income in 2004 on its investments abroad slightly exceeded income payments on foreign-owned assets in the United States. This pattern has been the norm for a number of years but, obviously, the net income flow will become negative if the U.S. net international investment position becomes sufficiently negative.

How is the United States able to earn a significantly higher return on its assets abroad than foreigners earn on their assets in the United States? Consider currency, which pays a zero return. A remarkable fact is that about half the total amount of U.S. currency outstanding is circulating abroad. Another fact is that much of the foreign holding of U.S. debt is in the form of Treasury bills and other debt instruments, while U.S. residents hold a much larger share of their assets abroad in the form of equities, thus earning an equity premium.

More generally, many private and governmental investors abroad rely on the U.S. capital market as the best place to invest in extremely safe and highly liquid securities. Along a spectrum of safety and liquidity, these assets include currency, U.S. government obligations, agency debt, and corporate bonds. U.S. equity markets are also highly liquid. The United States as a whole earns a return from providing these safe and liquid investments to the world. The desire of foreigners to hold U.S. Treasury securities is a testament to the confidence that the world has in the safety and soundness of our financial system.

Part of the reason U.S. capital markets have unrivaled strength in the world economy is that U.S. financial institutions provide services of extremely high quality. In the detailed trade accounts, we see that the United States has a lop-sided trade advantage in financial services. In 2004, U.S. exports of financial services amounted to $\$21.9$ billion, against imports of such services of only $\$5.0$ billion. Another line in the table of trade statistics tells the same story: business, professional and technical services yielded U.S. export earnings in 2004 of $\$33.8$ billion as against imports of such services $\$12.5$ billion. Some of these services, such as legal and accounting services, are closely connected to success in financial services trade.

HOW DANGEROUS IS THE U.S. CURRENT ACCOUNT DEFICIT?

In light of these considerations, let us return to our question: How dangerous is the U.S. current account deficit? The first thing to note is that many of the economic forces driving capital flows are very long term. Portfolio reallocations occur as home bias declines, but over years rather than quarters. Firms build operations in other countries based on plans extending many years in the future. Demographic developments unfold over decades. What may appear to be an imbalance from a short-run perspective may make perfect sense over a long-term horizon.

To the extent that adjustment of the current account will involve changes in the foreign exchange value of the dollar, it is quite likely that such changes will take place gradually over time in orderly markets. There is no inherent reason that such changes would lead to a financial market crisis; as a stable, diversified and growing economy, the United States is not likely to suffer from a sudden lack of confidence by investors. Of course, sustained confidence does depend on sound economic policies, as I have already emphasized.

It is sometimes said that the United States has become a “net debtor” nation, and that this

situation increases the risk that currency depreciation might lead to financial crisis. Indeed, with a current account deficit amounting to 6 percent of GDP and a negative net international investment position over 20 percent of GDP, some have drawn comparisons with countries such as Argentina, Brazil, Mexico and other countries that at times have experienced severe balance-of-payments crises. I consider it highly unlikely that such a crisis will befall the United States.

The word “debtor” is extremely misleading in this context, for the U.S. assets owned by foreigners include equities and physical capital located in the United States, in addition to bonds issued by U.S. entities. Moreover, the part of the U.S. international financial position that is debt, by which I mean bonds and other fixed claims such as bank loans, is predominantly denominated in dollars. In fact, about 95 percent of international claims on the United States are denominated in dollars. A country with most of its debt denominated in its own currency is in a very different situation from one whose debt is denominated in other currencies. The familiar crises experienced by several Asian countries in 1997-1998, by Mexico on several occasions, and by numerous other countries have all involved situations in which the impacted countries have had large external debts denominated in foreign currencies.

In these previous crisis scenarios, the foreign denomination of domestic debt had important destabilizing consequences. Consider what typically happens to a country suffering a balance-of-payments crisis. As the foreign exchange value of its currency depreciates, the value of its foreign liabilities—in terms of domestic purchasing power—increases, as does the burden of servicing its international debt. Recognizing this implication of a crisis, international investors respond by paring back their positions further, engendering even greater currency depreciation. Hence, the combination of foreign-denominated debt and a depreciating currency has proven to be something of a vicious circle—compounding and accelerating a crisis.

The U.S. situation is completely different. To the extent that the foreign exchange value of the dollar declines, the effect on the values of U.S. and foreign asset holdings works not as an accelerator of crisis, but as part of a self-correcting mechanism. Dollar-denominated U.S. liabilities remain unchanged in domestic value, which means that debt service in dollars and relative to the size of the U.S. economy does not change. Moreover, holdings of U.S. investors abroad, about two-thirds of which are denominated in foreign currencies, appreciate in dollar terms. The composition of the U.S. international investment account, therefore, contributes to stability rather than to instability.

The significant quantitative importance of exchange rate changes on the U.S. net international investment position can be illustrated by examining specific periods in which the dollar appreciated or depreciated. Consider the years 2002-2004, during which the Fed’s major currencies trade-weighted exchange rate index depreciated by nearly 27 percent. Associated with the current account deficits during this period were financial flows into the United States totaling \$1.6 trillion. However, because foreign claims on U.S. assets are denominated in dollars to a far greater extent than U.S. claims on foreign assets, the depreciation increased the dollar value of U.S. assets abroad relative to foreign assets in the United States. The total valuation impact stemming from exchange rate changes was \$919.0 billion, which was 57 percent of the net financial flows. For this three-year period, the U.S. net international investment position decreased by \$202.8 billion, but absent the exchange rate adjustment, the position would have decreased by more than \$1.1 trillion.

Now consider the years 1999-2001, to illustrate the impact of an appreciating dollar. During this period, the Fed’s major currencies trade-weighted exchange rate index showed a dollar appreciation of nearly 15 percent. Net financial flows into the United States totaled \$1.1 trillion. Meanwhile, the total valuation impact of the appreciating dollar was a negative \$548.2 billion, which is nearly half the size of the net financial

flows. For this three-year period, the U.S. net international investment position decreased by \$1.3 trillion. Absent the exchange rate adjustment, the decrease would have been \$684.4 billion. However, the negative international investment position did not threaten to cause dollar depreciation; instead, causation went the other way, as dollar appreciation caused a significant increase in the negative net investment position.

The effects of changes in the foreign exchange value of the dollar on the U.S. net international investment position serve to stabilize the international sector of the U.S. economy. Clearly, as the previous illustrations show, it is a mistake to ignore valuation changes because they are not insignificant compared to the annual financial flows that are the counterpart of the current account deficit.

Certain other industrialized economies have incurred much larger external obligations as a percent of GDP without precipitating crises. For example, Australia's negative net investment position reached 60 percent of GDP in the mid-1990s, Ireland's exceeded 70 percent in the 1980s, and New Zealand accumulated a position amounting to nearly 90 percent of GDP in the late 1990s. Notably, these economies have recently been among the most successful—in terms of economic growth—in the industrialized world. The combination of rising external obligations and prospects for robust growth is entirely consistent with the view of the capital account I have discussed today. Capital flows to countries that can make productive use of it. Capital inflow is a symptom of good growth prospects and an aid to growth rather than an impediment.

A recent study by Federal Reserve economists at the Board of Governors buttresses this view.³ The authors of the study—Croke, Kamin, and Leduc—systematically examined examples of developed industrial nations that have experienced current account “reversals.” They found that such reversals have typically been benign: among those countries that experienced the largest

declines in growth during the adjustment period, cyclical considerations appeared to be an important factor. Moreover, these cases were generally not associated with significant exchange rate depreciations. Among those cases where countries weathered the adjustment while experiencing increasing economic growth, exchange rate adjustments were an important factor in reducing current account deficits—primarily by raising export growth rather than lowering imports. In these cases, the exchange rate depreciation evidently played a role in buffering those economies against adverse growth consequences.

These findings provide little evidence in support of the disorderly markets scenario and are entirely consistent with the view I have emphasized. To be sure, no country can permanently incur rising levels of net external obligations relative to GDP. If sustained indefinitely, service payments on ever-increasing obligations would ultimately exceed national income. Long before that situation of literal insolvency occurred, however, market forces would drive changes in exchange rates, interest rate differentials and relative growth rates in such a way to move the economy toward a sustainable path. Nevertheless, such adjustments need not be sudden, large or disruptive as they have sometimes been for countries with severe balance-of-payments crises.

The international capital markets view suggests that the United States is more like those countries that have experienced high levels of debt without obvious ill effects than those that have suffered crises. Moreover, the U.S. case is unique in a number of respects. The central role of U.S. financial markets—and of the dollar—in the world economy suggests that capital account surpluses, and therefore current account deficits, are being driven primarily by foreign demand for U.S. assets rather than by any structural imbalance in the U.S. economy itself.

The situation facing the United States is deeply different from that facing nations that have experienced painful current account adjust-

³ Croke, Kamin, and Leduc (2005).

ments. But while the U.S. situation might be quite distinctive, it would be a mistake to think that the United States is in completely uncharted waters; as noted, other prosperous countries have had large negative international investment positions without getting into trouble, and the United States itself was in this position for decades prior to World War I.

CONCLUDING COMMENTS

The international financial markets view of U.S. international capital account determination that I have described today highlights the dynamic role of international capital adjustments as investors exploit the opportunities of globalized financial markets. Because the technological progress and capital-market liberalizations that have driven this process have evolved over time, the process has been protracted. Ultimately, however, when portfolio adjustments have optimally exploited new diversification opportunities, and as growth abroad rises, the net international investment position of the United States will stabilize. So also, over time, will the current account deficit decline to sustainable levels.

If the capital markets view is correct—and I obviously think it is—the forces driving the U.S. capital account represent a persistent, but ulti-

mately temporary, process that might result in a higher negative level of net claims without necessarily posing any threat to the long-run sustainability of the U.S. current account. Nor will the transition to a sustainable long-run path necessarily require wrenching adjustments in domestic or international markets or in exchange rates.

We can all benefit from our good fortune in having access to increasingly safe, liquid and transparent financial markets. The United States has created for itself a comparative advantage in capital markets, and we should not be surprised that investors all over the world come to buy the product.

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